

Emissions Trading and the next Recession we have to have

It appears from the Garnaut Review Team's Interim Report that the plan is to auction emission permits equal to the total emissions of each enterprise or plant to be covered by the ETS, less the targeted annual reduction from its baseline 2000 level. Warwick McKibbin's Submissions to the Review also mention auctioning allowances equal to 100 per cent of the capped level of emissions.

There appears to have been little discussion of the macro-economic implications of such an auction. The AGO's National Greenhouse Accounts 2006 state that Australia's total emissions of GHG in 2005, excluding agriculture, were 430.9 million tonnes of carbon dioxide equivalent. If we assume that the average auction price per tonne of CO₂e that would emerge would be at least similar to that at which emissions credits trade in the EU, namely about Euro 23 per tonne, which is A\$40 at the current exchange rate, then the government could well receive a total of at least A\$17 billion from its first round of auctions. But recalling that so far emission allowances have been issued free in the EU, it could be expected that the price of allowances in Australia will be significantly higher, because first, they will have to be bought at auction, and because secondly, the supply of emission credits from achieved reductions will be less than the current emissions of each affected enterprise, the effective price could well rise to A\$65, as envisaged by the recent McKinsey Report, producing potentially A\$28 billion.

The Review Team should be well aware that the ATO is more efficient at collecting revenue like that from an ETS auction than the Treasury or the Department of Climate Change are likely to be at spending this amazing windfall. Will the Treasurer's 2009-2010 Budget have in place ways of recycling that \$28 billion as soon as it comes in, and in ways that do not finance any new emissions? If not, his recession will be much more spectacular than Paul Keating's "the recession we had to have" because of the dramatic reduction in money supply that such an initial auction would have, being well in excess of the projected Commonwealth budget surplus in 2007-2008. Not only will the deflationary effect be very large, the impact on company balance sheets will be awe-inspiring, although that will with a lag of at least a year be partly moderated by presumed tax deductibility of the cost of emission permits.

The Interim Report appears to be very excited by the size of this \$400 billion market and by the volume of the resulting trading to be channeled through its "Reserve Bank for Carbon". However I suggest that instead of auctioning allowances equal to 100 per cent of the level of capped emissions, if the primary intention of the ETS is emission reduction, then that can be achieved with far less macro-economic and commercial disruption by auctioning permits only in the number needed by enterprises to allow them to emit *above* their capped level.

For example, the gas, electricity and water sector emitted around 200 mtCO₂e in 2005. If it had to buy permits equal to its capped emissions, at say 198 mtCO₂e, that would create an upfront cost of \$13 billion, enough to drive some perhaps many out of business unless they are allowed by regulators to pass on that very substantial cost. To give an idea of the cost for my own fairly typical Canberra household, which

according to ACTEW could be responsible for 20 tonnes of CO₂e a year, the cost without any flow through of margins would add \$1,300 (60 per cent) to its annual electricity costs.

At the very least if only as a transitional measure, serious consideration should instead be given to limiting the permits to be sold at auction to just **the incremental amount above the cap that enterprises might need to purchase**. Thus the scale of the auction would be say 0.5 per cent of base-year emissions, if 99.5 per cent is the first year cap, rising to 1%, as the cap drops to 99% of base year emissions, and so on.

Using this system, *and conducting the auction on a monthly rather than annual basis*, the first month's auction and market value would be A\$9 million for a total first year yield of \$140 million (based on a reduction of 0.005% of 430.9 mtCO₂e – from all sectors except agriculture - times \$65), but rising by about those amounts in every subsequent year. The essence of this approach is that it impacts only on the **marginal cost** of emitting above the cap of 99.5% in the first year, but that is what matters for promoting carbon reduction.

The reported remarks by Don Voelte, CEO of Woodside (*The Australian*, 10th April 2008) that as presently envisaged the Garnaut ETS would close down the North West Shelf's LNG exports, and by Christian Balme, a director of Royal Dutch Shell, that it would cease all new investment in the EU if it persists with its announced plans to auction ETS permits equal to total emissions in future (*The Australian*, 11th April 2008), show the dangers of the ETS as apparently envisaged in the Garnaut Interim Report. My approach would go far to allay the fears expressed by Messrs. Voelte and Balme.

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